California's Lessons for Trade and Monetary Integration:

Gains from Trade and Investment versus Fiscal Sovereignty

Daniel J.B. Mitchell*

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* **Ho-su Wu Professor, Anderson Graduate School of Management and School of Public Affairs, UCLA. Address: Anderson Graduate School of Management, UCLA, 110 Westwood Plaza, Los Angeles, CA 90095-1481 USA. Telephone: 310-825-1504; Fax 310-829-1042; E-mail: daniel.j.b.mitchell@anderson.ucla.edu.**

If one were looking for an attribute that characterized most countries for much of the 20th century, having a unique currency would be a good choice. Most countries issued their own currencies and determined their currency exchange rate regimes. But creation of the euro-zone within the E.U. represented a change in the concept of a country. Member nations in the euro-zone became akin to regions within traditional countries.

Students in international economics courses are immediately introduced to David Ricardo's model of "comparative advantage." This model involves island economies whose only contact is through trade. The implication is that all countries have relative advantages, regardless of their absolute efficiencies. Given that starting point, economists tend to look askance at business types who speak instead of "competitive advantage," which suggests absolute efficiency and cost are important in the international context. Competitive advantage, in the economists' view, is a concept valid only *within* a country for competition between regions or firms.

However, a major deviation from the Ricardian model has long been present: factor mobility. Capital is mobile, whether thought of in the financial sense or as trade in capital equipment. And labor mobility exists between countries, although labor is less mobile than capital. Once we add monetary integration to factor mobility, the concept of competitive (absolute) advantage becomes more and more relevant to international commerce.

Indeed, the overriding theme below is that countries that integrate monetarily are more analogous to sub-national entities than to traditional nations. The constraints of monetary integration are explored using California – a sub-national entity – as an example. But also noted is the fact that California enjoys the advantage of a larger national system of financial regulation that protects its commercial banks and other similar institutions.

Countries that give up their currencies for someone else's do not necessarily receive such external protection. Yet financial protection is something that countries without national currencies clearly need. Even countries that integrate monetarily through currency boards and the like – while retaining a national currency - expose their financial systems both to normal financial risk and exchange rate risk. When both types of risk are present, the need for financial protection is even greater.

A major subtext of this paper is that countries without currencies or without independent currencies lose fiscal autonomy as well as monetary. That implication is especially important for issues of social insurance since such programs are essentially components of fiscal policy. Even general regulation of labor markets through policies mandating minimum wages, benefits, and working conditions is constrained by lack of a national monetary regime, since the significance of absolute or competitive advantage is elevated.

Financial markets are much closer to the textbook model of perfect competition – with its "law of one price" – than are goods markets. That law suggests that due to arbitrage, it is difficult to separate markets. Local sovereignty is therefore extremely limited. The implication is that, although trade integration is important, national sovereignty is much more likely to be compromised on the monetary side than on the trade side. Attempts to promote labor standards and social insurance confront monetary as well as trade constraints. The former may well be more binding.

The U.S. Monetary Union

Within the United States, there are fifty states with limited political sovereignty relative to the central government. However, all are linked through a customs union. There is free trade among them while exports to, and imports from, outside the U.S. are exclusively regulated by the federal government.[1] All states are part of a common market for goods and factors; labor and capital mobility is internally free within the U.S. All are part of a monetary union; there is only one "dollar" within the U.S. State governments do not have separate currencies and exchange rates. In the discussion below, we examine the implications from the viewpoint of California, by far the largest state within the United States, drawing on both history and recent events.

Learning from a Sub-National Case

It could be argued that the history of a jurisdiction within a country is of little importance in understanding globalism. But the opposite is true. Today, countries face choices about both their degree of trade and monetary integration with the outside world market. The currency question is often posed as simply fixed vs. flexible. But there are many variations extant in the international arena. Among the options is the choice to use someone else's currency or to peg very rigidly to another currency.

Countries retaining national currencies can take a *laisser-faire* position regarding exchange rates, letting market forces have free reign. They can engage in managed floating. They can peg to a basket of world currencies. They can peg to a single currency, perhaps using a currency board. Or they can abandon their currency and use someone else's instead, as in the euro case or in the case of "dollarization." The euro or dollarization options abandon what we have noted as the hallmark of the modern nation, at least through most of the 20th century. California's experience within the U.S. illuminates the choices and consequences, particularly the choice of having no local currency.

Post-World War II International Integration

Notable examples of trade integration developed in the post-World War II era. The most striking example – already noted - is the European Union, originally started as a limited customs union with six countries, now a far-reaching arrangement embracing many more countries, labor and capital mobility, harmonization of national regulatory systems, and – for a subset of its member states – a currency union. Each E.U. country, however, has retained its own social insurance arrangements such as pensions and health insurance – an important deviation from harmonization. And labor laws, standards, and conditions differ substantially across the various member states, despite "Social Europe" efforts at specifying minimum standards.

If the E.U. stands out in terms of its larger political agenda, it also exhibits significant tensions concerning ultimate objectives. A notable E.U. event was the rejection of a proposed constitution by France and then Holland in 2005. Both of those countries were among the original six that formed what was then the European Economic Community in the late 1950s. But both had chosen to abandon their currencies for the euro. And that fact suggests that a popular sense developed that the euro decision had unforeseen costs going beyond conversion of cash registers to a new unit of value. Perhaps if France and Holland had taken a close look at the position of the fifty states within the U.S., they would not have so readily given up the franc and guilder.[2]

Trade vs. Money: The General Issue

From the viewpoint of international trade theory, the idea that trade integration is less of an encroachment on domestic economic developments than monetary integration is not obvious. Under the Heckscher-Ohlin model, integration of trade markets (exports and imports) produces an indirect linkage of factor markets, even without actual factor mobility. Factor prices – wages in particular - are supposed to equalize. While there may well be tendencies of this sort, the empirical fact is that substantial differences in wages across countries remain.

Convergence in financial markets is easier to find. German and Italian interest rates were quite different (reflecting Germany's tendency to have a lower inflation rate than Italy) until monetary integration, as Figure 1 dramatically illustrates. Similarly, in the heyday of the Argentine peg to the dollar in the 1990s, the vast difference between U.S. and Argentine interest rates was greatly diminished.[3]

While undoubtedly an influence on wages, the trade effect operates with the speed of molasses. Very large national differences can persist in wages and living standards for long periods of time. Levels of economic development seem more important in determining wage levels than trade. But financial markets – once exchange rates are stabilized (or eliminated as in the euro case) – bring much more rapid and dramatic convergence of interest rates.

Trade vs. Finance Within the U.S.

The trade vs. finance contrast within the U.S. is especially striking. It is not possible even to talk of state differences in interest rates within the U.S. Anyone, regardless of location in the U.S., receives the same interest rate on federal Treasury securities. All major financial markets are tied together electronically. Interest differentials across assets relate to risk and term of maturity, not geography.

In contrast, wage differentials exist regionally with in the U.S. Average wages vary substantially across states, as Table 1 illustrates. But even *within* industries and occupations, regional differentials remain. Although the U.S. has a relatively high rate of internal mobility – compared, for example, to European countries – labor markets are simply not anywhere near as fluid as financial markets.[4] There is no law of one price within the U.S. labor market.

Moreover, regional labor markets have a large element of local services which are not easy to outsource. These include retail, health, much of the public sector, education, etc. In theory, product market competition in tradable goods could equalize wages throughout the U.S., a national variant of the international Heckscher-Ohlin model. But as in the international case, significant pay differentials nonetheless persist.

California: A Sub-National Economic Entity Within the U.S.

California is the largest state in the U.S. In 2005, it accounted for over 11 percent of U.S. nonfarm payroll employment, over 12 percent of the population, and over 13 percent of personal income and GDP. California politicians and boosters love to compare California's Gross State Product (GSP) with the GDPs of various countries. Depending on the exchange rate, the state shows up as something like the 6th largest "country" in the world. Of course, California isn't a country. And when politicians brag about the state's rankings relative to other countries, they typically do not correct for purchasing power parity. However, there is no disputing that California is a very large economic entity. The question is – as a non-country that is totally integrated by free trade, factor mobility, and currency into the rest of the U.S. - what economic sovereignty does California have? And the answer is "not much," despite its size.

Direct Democracy

In the early 20th century, California was a center of the "Progressive movement." Precipitating factors in the state included a perception of corruption of the legislature by railroad interests and a related battle in the Los Angeles area concerning the location of its seaport. Under the reformist governor Hiram Johnson (elected in 1910), the state adopted a series of electoral reforms including the initiative, referendum, and recall. Also adopted were women's

suffrage and workers' compensation insurance. Although recent scholarship has provided a more nuanced interpretation of the events leading to the progressive reforms, their legacy remains. (Orsi 2005)

Under California's initiative process, legislation - including state constitutional amendments - can be submitted directly to voters through a petition process. Statutes enacted by the Legislature can be repealed by voters in referendums which are also triggered by petitions. State and local elected officials can be removed from office and replaced before their terms expire through recall elections. The most notable example was the 2003 recall of Governor Gray Davis and his replacement by Hollywood celebrity Arnold Schwarzenegger.

California's direct democracy gives the state a populist tilt in its politics. The initiative process can lead to legally-questionable but popular statutes being enacted. Generally, the political parties in California have been weak since the Progressive reforms. Individual candidates and causes become political bases instead.

Economic Constraints

There are substantial constraints from being part of the U.S. trade and monetary union. Usually, these are expressed politically as concerns about "competitiveness" and job loss. Thus, in principle California is free to set its minimum wage at the level it wants – and it does set the minimum above the federal standard. However, complaints that the state would lose jobs to other states which have lower minimums limit the degree to which California will move.

Since California has no separate currency or exchange rate with the rest of the U.S., mandated costs are add-ons to wages. Generally, economists believe that a substantial fraction of such mandates are shifted back to labor, i.e., that wages adjust to absorb some of the cost. But minimum wages are an absolute floor and mandates affecting minimum wage workers cannot be shifted back. Moreover, given downward wage rigidity, the degree of shifting, even for higher wage workers, may be limited in the short run. Thus, the absence of an exchange rate (which could accomplish such a shift even with downward nominal wage rigidity) tends to intensify resistance to mandated cost increases.

Absence of Macro Policy

The standard tools of national macroeconomic policy are monetary and fiscal. It goes without saying that countries – or economic entities – without a currency do not have monetary policy. Rather, they are dependent on the monetary policy of whoever's currency they use. They do have fiscal policy – government spending and taxation – but its use is highly constrained by the decision to give up monetary sovereignty.

Budget deficits can occur only if the country (or entity) is willing either to run down existing reserves or to borrow. Any borrowing it does inherently is in someone else's currency if it doesn't have one of its own. Reserves cannot be run down indefinitely or they will disappear, leaving borrowing as the only way to continue deficit spending. And increased borrowing implies rising debt service loads and increased default risk perceived by creditors. Interest costs rise as risk premiums increase, and – eventually – there will be difficulty in borrowing at all.

California is an entity without a monetary policy since the state has no local currency. It is interesting, therefore, to contrast its experience with that of Canada which *does* have a currency. Canada had a population of about 32 million in 2004 in contrast with California's 37 million. Canada had a GDP – measured in US dollars in 2004 adjusted for purchasing power - of about $1.0 trillion in contrast to California's GSP of $1.4 trillion. Canada's foreign trade is heavily with the U.S. Goods exports to the U.S. accounted in 2003 for 86% of total Canadian exports; imports from the U.S. accounted for about 61% of total Canadian imports.[5] Goods exports to the U.S. were about 25% of its GDP and imports were about 14%. Were services included, these ratios would be about 3-5 percentage points higher.

Because California is not a country, there are no estimates kept of its "exports" to and "imports" from the rest of the U.S. Since the state cannot tax or regulate such trade, no one stands at the border counting it. However, rough estimates have been made for another West Coast state – Washington – by its Office of Financial Management. In 1997, exports of goods *and services* (to the rest of the U.S. and elsewhere) were roughly 60% of Washington's GSP. Imports were about two-thirds of GSP.[6] It is likely that similar high ratios exist for California.

Although NAFTA was in effect in 1997, Canada was significantly less integrated into the U.S. product market than the border state of Washington despite the absence of trade barriers. Some of that discrepancy – which, as noted, we can assume also would apply in a comparison between Canada and California – may be due to the lack of a monetary union between the U.S. and Canada, a *de facto* trade barrier. A plausible hypothesis is that monetary union (as between the state of Washington and the rest of the U.S.) fosters increased trade integration.

What is clear is that California is more tightly linked to the business cycle of the rest of the U.S. than Canada. Figures 1 and 2 show, respectively, the annual percent change in employment (1961-2004) in California vs. the rest of the U.S. and in Canada vs. the U.S. Both figures – not surprisingly - show reasonably strong associations. But the correlation coefficient in the U.S.-Canada case (R = .64) is lower than in the non-California U.S.-California case (R = .84). In summary, Canada – which has its own monetary system – appears to have more macro sovereignty relative to the U.S. than California.

California's Fiscal History

California's history as a constrained economic entity within the U.S. trade/factor/monetary union has periodically produced popular frustration. Public programs and policies that appeal to voters must somehow be financed. When combined with direct democracy and weak party structure, that frustration has produced a series of episodes in which populist pressure bangs up against the constraint. Political leaders in the state then face the challenge of raising taxes, cutting back programs, or convincing voters that they can get what they want only if they are willing to pay for it. While the history of this tension is rich, space limitations permit only a few brief sketches.

I have elsewhere outlined the history of the U.S. monetary debates regarding adherence to the gold standard in the 19th century and its legacy under Bretton Woods and beyond. (Mitchell 2000a) What that history produced in the early 20th century, however, was a Democratic Party that was suspicious of the gold standard and a Republican Party favoring "sound money" (gold). This tension took on special importance during the Great Depression of the 1930s when the Democrats took the presidency from the Republicans. The link to gold was severed by the early New Deal administration which then experimented with the monetary regime. Generally, monetary experimentation was in the air and this new atmosphere was reflected in various California political movements.

EPIC

California was a Republican state in the early decades of the 20th century. However, the Great Depression roiled state politics. The first symptom came in 1934. Upton Sinclair, a well-known author, reformer, and (up to that point) socialist, managed to win the Democratic gubernatorial primary touting his campaign to End Poverty in California (EPIC), in effect a program to end the depression in the state. The EPIC plan was centered on the idea that workers and farmers should take over idle farms and workplaces and operate them as cooperatives. These takeovers were to be financed by the state government.

A major difficulty with the EPIC plan was that tax revenue had fallen sharply due to the Depression. So Sinclair proposed a state-level currency scheme to pay for his proposed EPIC takeovers. The fact that there was a monetary constraint was apparent and the currency proposal was his way of responding to it.

Sinclair's campaign created great popular fervor. EPIC clubs sprang up throughout the state. Democrats for the first time outnumbered Republicans as new voters flocked to register for the election. As noted, the federal New Deal monetary policy featured unorthodox approaches to gold and currency. So the idea of a state scheme founded on a California currency – which seems bizarre in hindsight – did not seem so farfetched in the mid-1930s. Indeed, in the

Canadian province of Alberta, the social credit movement – also a locally-based currency scheme – took over the provincial government in the 1930s.

It appeared for a time that Sinclair, who was facing a colorless Republican incumbent opponent, could win. A massive campaign to defeat Sinclair was mounted by conservatives, business interests, and old-line Democrats who resented the capture of their party by EPIC supporters. Ultimately, the anti-Sinclair campaign succeeded in defeating him but the EPIC movement left a residue on state politics for many years.

Ham and Eggs

In the 1930s, California's population was relatively elderly compared to the U.S. average. Cheap land and good weather attracted oldsters from other parts of the country. Various movements arose in California with demands for public old age pensions. (Mitchell 2000b) The most significant of these was the Townsend movement of the 1930s, which backed a *national* plan to pay everyone over age 60 $200 a month, a very large sum in that era. In exchange, the elderly would promise not to work, thus leaving what depression jobs there were for the young. The Townsend plan was to be financed by an ill-designed tax scheme.

Although the California-based Townsend plan was never adopted, it became the radical alternative to the Roosevelt administration's Social Security program and was a major factor in passage of that program. However, at the state level, California pensionites regrouped into the "Ham and Eggs" movement run by a colorful collection of con-artists. In 1938, the Ham and Eggs movement took advantage of California's direct democracy putting on the ballot an initiative promising to pay everyone in the state over age 50 "$30 Every Thursday." Instead of a Townsend-style tax as a financing mechanism, the Ham and Eggers borrowed the EPIC idea of creating a state currency, basically a stamp money plan. Outrageous behavior and corruption of the Ham and Eggs leaders ultimately defeated the 1938 initiative. Even so, it captured 45% of the vote and likely would have passed if the Ham and Eggs leaders had behaved themselves.

Both EPIC and the later Ham and Eggs movement were based on a kernel of truth. California was faced with the Depression but – absent a monetary policy – had little scope to do anything about it. While the state had a fiscal policy, the decline in tax revenue associated with the Depression forced spending cutbacks, not anti-Depression expansions. The ability to run a deficit was sharply limited by the fact that the state had to borrow in a currency it did not produce.

Postwar Policy

California's economy went from depression to boom during World War II, due especially to the sharp growth in its military aircraft and shipbuilding facilities. The state budget shifted into large surpluses. California's Republican Governor, Earl Warren, feared that after the war the legislature would dissipate the accumulating reserves in an orgy of spending. Warren felt that the wartime reserve would be needed to deal with future economic downturns. But he also had ambitious postwar plans for state programs of his own.

The state's population grew dramatically during and after the war. War workers were attracted by the upsurge in military production. In the immediate postwar era, many GIs resettled in California. Warren saw the necessity of infrastructure expansion. He saw needs for new housing, roads, schools, and university capacity. However, given his view that the state should maintain a "rainy day" fund for emergencies, he proposed new taxes to finance these plans. The difficult fiscal history of the state in the 1930s was something he did not want to repeat. And he was not going to finance his programs through utopian state currency schemes.

One of Warren's most tangible legacies was the California freeway system which he proposed to finance with a tax on gasoline and other motor-vehicle related taxes. A major battle arose, the opposition being led by oil companies that did not want gasoline taxed. In the end, Warren was able to rally public support to push the legislature to adopt his gasoline tax plan and begin expanding the road network. Warren was not always successful in having his program adopted. He proposed a total of three plans for universal health insurance, all to be financed by employer and employee payroll taxes. Warren's health plans were defeated repeatedly through major lobbying by California doctors.

The major lesson is that Warren recognized that since the state had no monetary policy, its fiscal policy was tightly constrained. Thus, the key to adopting new public programs was obtaining sufficient popular support for the taxes needed to pay for them.

The Golden Era and Its Aftermath

The governorship of Democrat "Pat" Brown (1959-67) is today depicted as a golden era in California due to Brown's success at expanding the freeways, formalizing and expanding the state's various higher education systems, and creation of a major water project. Brown initially followed the Warren approach. He raised taxes substantially upon taking office for his proposed programs.

But during his second term, the state ran into fiscal difficulties as it attempted to finance Brown's various plans along with a variety of new social programs. In what turned out to be his final year in office, Brown ran for a third term against movie star Ronald Reagan. Brown also ran a very substantial budget deficit which neither he nor the

legislature were anxious to address in an election year. Reagan campaigned on a conservative platform of shrinking state government and, upon taking office, proposed 10% across-the-board cuts for all programs. When that proved infeasible, Reagan raised all major taxes substantially, thus addressing the inherited Brown deficit. The conservative Reagan simply did not view continuing with deficits and borrowing as a viable option for California.

Reagan in fact raised taxes more than once as governor and departed from office in 1975, leaving the state with a significant reserve. He hoped to capture the Republican presidential nomination in 1976, but felt that he had to leave a legacy in California other than tax increases and increased spending to attract conservative support. Reagan therefore attempted to use the initiative route to pass a complicated budget plan designed to accomplish his original goal of cutting the size of state government. The plan – whose supporters and designers included a group of well-known academic economists (such as Nobelists Milton Friedman and James Buchanan) - failed at the ballot box, due partly to its complexity and partly to an ill-managed campaign. It involved defining a base ratio of state revenue to personal income and then ratcheting down the ratio by constitutional formula over a multi-year period.

Despite the failure of the Reagan budget-control initiative, its logic was based on the idea that California – as part of the larger U.S. monetary union – had little latitude for deficit spending. If tax revenues were constrained, Reagan and his supporters believed, spending would have to be limited. And as conservatives, spending limits were what they wanted.

The Taxpayer Revolt and the Recall

Rising property values in the 1970s led to a taxpayer revolt, as property tax bills soared. In 1978, voters passed Proposition 13 which drastically cut and limited the property tax and constrained other tax increases. The property tax had financed local governments including school districts. When that revenue was sharply curtailed, the state government initially “bailed out” local authorities using reserves accumulated under Reagan and his successor as governor, Jerry Brown.

The recession of the early 1980s, combined with the bailout, exhausted the reserves. California has had a budget crisis during each recession thereafter. Recessions arrived in the early 1980s, early 1990s, and early 2000s. The early 1990s recession hit the Los Angeles area particularly hard due to the end of the Cold War and declining aerospace and military spending. (Garcia and Cohen 1993) The early 2000s recession was hard on the Silicon Valley area due to the dotcom bust. Popular frustration developed over the periodic fiscal crises and a tension between a desire to maintain or enhance public services without imposing taxes needed to cover costs. This frustration has led to

a series of ballot initiatives which constrain the legislature, direct state expenditures by formula, and limit the tax-raising ability of state and local authorities.

Democrat Gray Davis was elected governor in 1998, a time of prosperity and upsurge in state tax revenue associated with the high-tech/dotcom boom. Because the stock market was booming, and because the dotcoms compensated employees with stock or stock options, the growth of capital gains tax revenue was particularly dramatic. At the peak of the cycle, over a fifth of revenue going into the state's General Fund came from capital gains. The state budget became remarkably dependent on stock values which were dependent on a steady inflow of investment into high-tech/dotcom enterprises. But also at the peak, the state was running a small deficit. As the economy and the stock market turned down, state reserves were quickly exhausted.

Davis won re-election in 2002, due to a weak Republican opposing candidate. But raising taxes and passing a budget both required a two-thirds vote of the legislature. In Davis' final years, the legislature deadlocked - with Republicans refusing to raise taxes and Democrats unwilling to cut spending enough to balance the budget. At times the state had no budget, leading to legal problems in paying suppliers.

Paralysis in the legislature ultimately led to a gubernatorial proposal to borrow long-term to finance ongoing operations, something Reagan never contemplated nor did his gubernatorial successors in previous crises. Davis was recalled in 2003, thanks in part to the budget crisis, before his bond could be floated. He was replaced by movie star Arnold Schwarzenegger who promised to deal with the state's fiscal ailments without raising taxes. That logic ultimately led Schwarzenegger to propose a variant of the Davis bond that was approved via initiative. The bond was characterized as a one-time remedy after which the budget imbalance would be repaired and the state would "throw away the credit card."

Unfortunately, the structural budgetary problems remained and the state enacted another deficit budget for fiscal year 2005-06. With no solution in sight, and with a stalemate in the legislature, Governor Schwarzenegger went the Reagan route, proposing a complicated budget control initiative. This proposal morphed into a contest between the governor and public-sector unions.

Governor Schwarzenegger and his allies ultimately put four items on the ballot in a special election called for November 2005. Only one dealt directly with the budget. Another dealt with drawing election districts for legislators. Two were aimed at public-sector unions. The theory behind this effort was that public-sector unions, along with their private-sector counterparts, favor enlarged public services which led to budget deficits. In the end, after a massive

counter-campaign funded largely by public-sector unions, all the governor's initiatives failed. Yet it is likely that the issues raised will re-appear if budget pressures continue. (Mitchell and Hirsch 2006)

Lessons from California

What can countries learn from the fiscal history of California, a sub-national economy? Economic entities without monetary policy are constrained in their fiscal policies. As a result of its budgetary stalemates of the early 2000s, California had the lowest bond rating of any of the 50 states. While it can continue for awhile with deficit financing, California's debt service costs are increasing; its ability to cope with future economic downturns has diminished. That is the fate of any entity – region or country - that must borrow in someone else's currency. Particularly striking is the contrast between the U.S. federal government – which borrows with abandon in dollars that it can create – and the California government that is increasingly constrained as it borrows in dollars it cannot create.

****Lesson #1: Surrendering monetary sovereignty diminishes fiscal sovereignty. Countries should not do the former unless they are prepared to accept the latter.***

Countries attaching themselves to another's currency face the same problem as California has faced as a sub-national entity. But they have another risk as well. Even if a public authority bankruptcy in California should occur, that event would not produce the kind of private-sector turmoil seen, for example, in Argentina when its dollar-peso peg collapsed. Key financial institutions in California are insured at the federal level; the state is not responsible. A public bankruptcy in California would not produce bank runs. Since California has no currency of its own, no exchange rate crisis can occur. Argentina, in contrast, was tied to the dollar but retained a national currency. And its financial institutions were not protected by the U.S. financial safety net.

While formal bankruptcy at the state government level in California remains unlikely, one of the major counties in the state – Orange County (with a current population of about 3 million) – did go bankrupt in the mid-1990s. The cause was failed speculation by the county treasurer in derivatives and refusal by county voters to raise taxes to cover his losses. Yet the private sector of the county was virtually unaffected by the bankruptcy. There were no runs on Orange County banks, which are federally insured and protected. And the county – home of a prosperous bio-tech industry - continued to grow in population and economic activity while its government's bankruptcy was being litigated.

****Lesson #2: Complete abolition of local currency ends exchange rate risk, thus partly insulating the private sector from being swept into public sector fiscal crises due to speculation about devaluation. Prospect of***

devaluation can lead to capital flight with adverse impacts on the local commercial and financial system. If there is no exchange rate, exchange rate risk is eliminated <u>but financial system risk is not</u>.

The Orange County and California cases suggest that countries which either abandon their own currencies (e.g., dollarization) or tie to someone else's currency via a currency board type regime, need substantial reserves of that other currency to back their financial systems. Unlike California, a country that tied itself to the U.S. dollar (or any other currency) cannot expect the U.S. federal government (or the issuer of the other currency) to avert a foreign financial panic. Only if a country has sufficient reserves to prevent or overcome such panics should steps such as dollarization be considered.

****Lesson #3: Substantial reserves are needed to back the private financial system when local currency is abolished or tightly pegged to another currency.***

Of course, these lessons from California do not indicate whether a country should dollarize or follow any particular currency regime. California obviously benefits greatly from trade and monetary integration with the rest of the U.S. The political movements of the Great Depression advocating creation of a California currency are understandable in historical context. But it would be hard to argue that California would have been net better off with a separate monetary regime from the rest of the U.S. Such a hypothetical regime might have cushioned the state against certain shocks such as the decline in aerospace after the Cold War or the dotcom bust. But it probably would also have limited inward investment flows and impeded state economic development over the long haul.[7]

The California experience, however, does highlight the fact that monetary integration and trade integration are not the same thing; the former need not follow in inevitable evolution from the latter. NAFTA countries are integrated on trade; not money. Absent a means of backing up its financial system to avoid Argentine-type collapses, a country should be very careful about surrendering monetary sovereignty. Monetary sovereignty is of potential value in averting crises and exerting economic control of a country's destiny. It may well be that countries in the euro-zone are coming to regret the surrender of their separate monetary regimes.

There is a more general lesson to be learned from the study of a sub-national economy such as California. International economics textbooks inevitably begin with David Ricardo's model of "comparative advantage." The Ricardian model – developed in the early 19th century - depicts island economies without explicit monetary systems. These economies barter exports for imports. There is no international factor mobility across their borders and the only economic contact between the island economies is via trade in goods.

The modern world is quite different. There are national monetary systems and barter is comparatively rare. While simple models may depict monetary systems as fifth wheels on the barter model, the fact is that monetary policy has real economic effects. Factor mobility across international borders is part of contemporary reality. Capital mobility – whether conceived as financial flows or as trade in capital goods – is the norm. Labor mobility, while certainly more limited than capital, is also a feature of the international economy.

****Lesson #4: Study of sub-national economies within larger national systems can provide important insights into international economic issues. The Ricardian model says nothing about monetary regimes. In a world in which capital can move relatively freely and labor mobility is increasingly occurring, studying California's gains (and losses) from trade and monetary integration may be more illuminating than focusing on the Ricardian model of isolated trading islands.***

Countries contemplating complete abandonment of monetary policy must be prepared to give up substantial fiscal sovereignty as well. They may well want to join a monetary union nonetheless. But they should be aware of the downside and – as California Governor Earl Warren once advocated – accumulate reserves for a "rainy day."

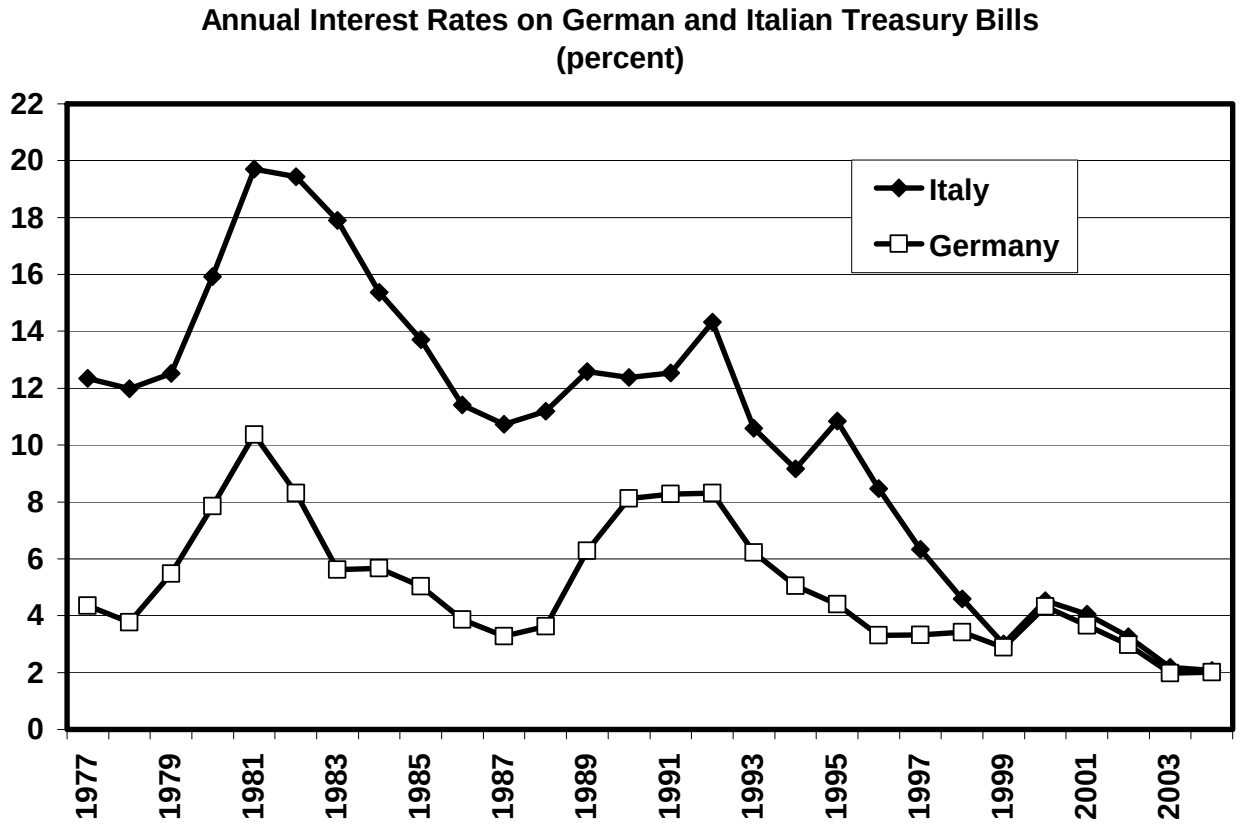
Table 1: Average Weekly Wage in Selected Industries the U.S. Private Sector: 2003

	Lowest Third of States	Middle Third of States	Highest Third of States
In U.S. Dollars			
Total	$557	$647	$807
Beauty Salons	296	331	374
Temporary Help	332	363	455
Residential Plumbing	535	643	708
Software Publishers	1135	1329	1798
Middle Third = 100			
Total	86	100	125
Beauty Salons	89	100	113
Temporary Help	91	100	125
Residential Plumbing	83	100	110
Software Publishers	85	100	135

Note: Industries listed above are NAICS 812112 (beauty salons); NAICS 56132 (temporary help services); NAICS 238221 (residential plumbing and HVAC contractors); NAICS 5112 (software publishers). "States" include District of Columbia.

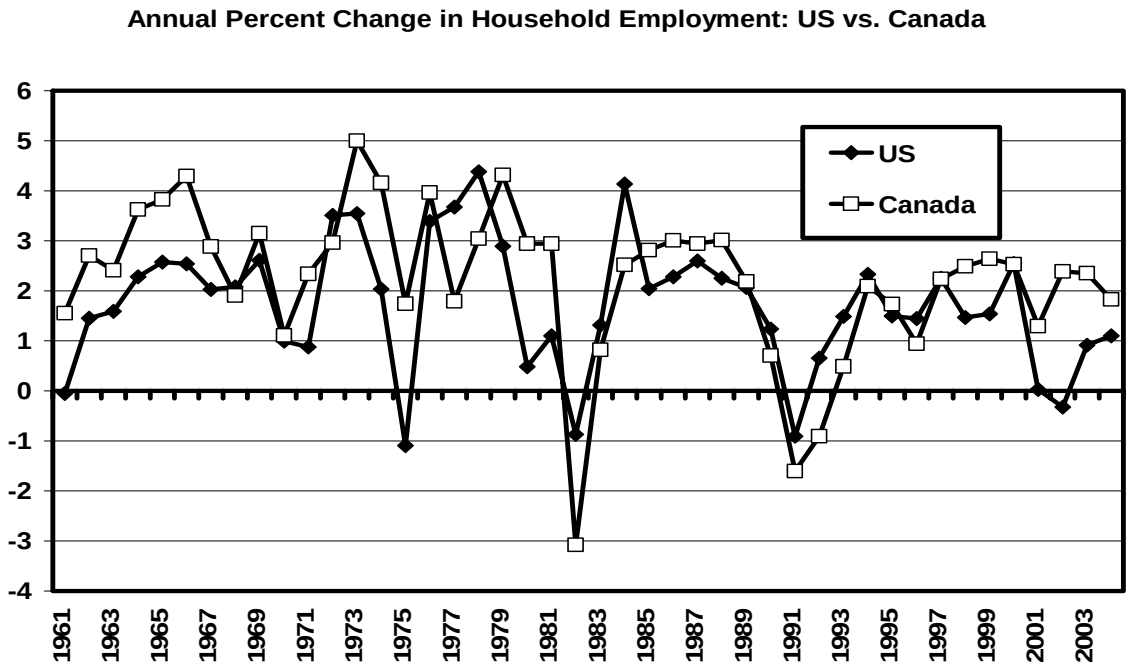
Source: U.S. Bureau of Labor Statistics (2004).

Figure 1



Source: Country data from International Monetary Fund website, www.imf.org.

Figure 2



Source: Data from U.S. Bureau of Labor Statistics website, www.bls.gov.

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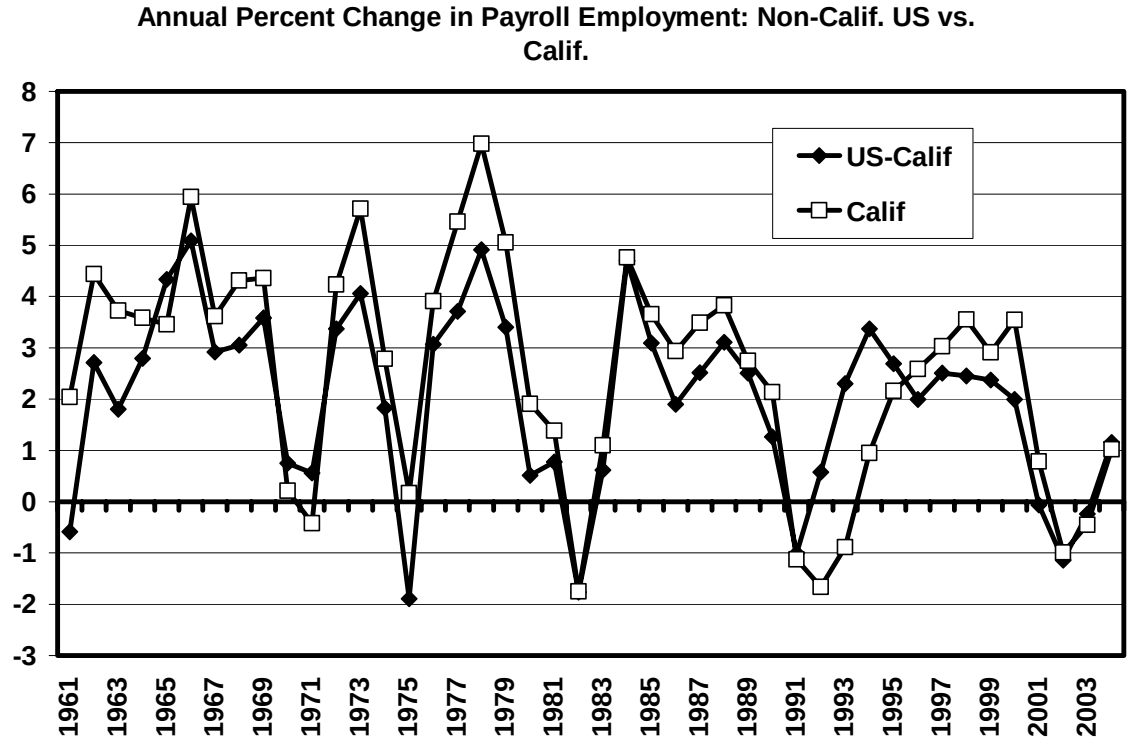
Figure 3



Source: Nonfarm employment data from U.S. Bureau of Labor Statistics website, www.bls.gov.

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Footnotes

[1] However, the U.S. stood out as high among OECD countries in the share of its sub-national governments in taxing and spending. See Joumard and Kongsrud (2003).

[2] Notably, voices in Italy began to be heard after the French/Dutch rejection advocating a return to the lire. Research on the euro-zone suggests that larger countries have done least well under the euro regime. (Hoeller, Giorno, and de la Maisonneuve 2004).

[3] Many commentators refer to the Argentine system as a "currency board." This shorthand has been criticized as inadequately characterizing the actual peso-to-dollar peg. For purposes of this paper, the precise peg mechanism is not relevant. See Schuler (2005).

[4] On comparative internal labor mobility, see chapter 2 of Organization for Economic Cooperation and Development, (2005).

[5] Data are from International Monetary Fund (2004).

[6] Data are from an input-output table prepared for Washington available at www.ofm.wa.gov/economy/io. The implicit GSP on that table is close to U.S. Bureau of Economic Analysis estimates of GSP.

[7] California has received heavy inflows of venture capital which might not have occurred in the face of exchange rate risk. See Horvath (1999)